

PROFESSIONAL CORPORATIONS IN OHIO: THE TIME FOR STATUTORY REVISION

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I. INTRODUCTION

On August 31, 1967, the latest, and possibly the concluding, round started in the long struggle to determine the tax status of professional service corporations. On that day, in *Empey v. United States*,¹ a federal district court in Colorado determined that a firm of attorneys organized as a professional service corporation under the general corporation laws of Colorado was a "corporation" for federal income tax purposes. *Empey* has since been followed, although the rationale has varied from case to case, in at least nine² other federal district court cases, and it has been affirmed on appeal. In addition, at least two³ of the other federal district court cases have been affirmed on appeal.

As a result of the publicity accompanying *Empey* and the cases that followed it and the strong desire by taxpayers who provide professional services to adopt qualified pension and profit-sharing plans and to secure the other federal income tax benefits available to corporations, a major, new, and largely unknown, area of the law is about to become a significant part of the practice of many attorneys. This area will presumably be called "professional corporations," and in Ohio will cause to be ranked alongside corporations, partnerships, limited partnerships, and limited partnership associations,⁴ a relatively new entity called a "professional association."

This article will examine the Ohio professional association statute⁵ and compare it with the professional association and professional corporation

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¹ 272 F. Supp. 851 (D. Colo. 1967), *aff'd* ___ F.2d ___ (10th Cir. 1969).

² *Williams v. United States*, ___ F. Supp. ___ (D. Minn. 1969); *Van Epps v. United States*, ___ F. Supp. ___ (D. Ariz. 1969); *Smith v. United States*, ___ F. Supp. ___ (S.D. Fla. 1969); *First National Bank & Trust Company of Tulsa Okla. v. United States*, ___ F. Supp. ___ (N.D. Okla. 1969); *Cochran v. United States*, ___ F. Supp. ___ (D. Ariz. 1969); *Holden v. United States*, 289 F. Supp. 169 (N.D. Ga. 1968); *Wallace v. United States*, 294 F. Supp. 1225 (E.D. Ark. 1968); *Kurzner v. United States*, 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd*, ___ F.2d ___ (5th Cir. 1969); *O'Neill v. United States*, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, ___ F.2d ___ (6th Cir. 1969).

³ *Kurzner v. United States*, ___ F.2d ___ (5th Cir. 1969); *O'Neill v. United States*, ___ F.2d ___ (6th Cir. 1969).

⁴ In Ohio and several other states limited partnership associations may be used as an alternative to professional associations or professional corporations. Although a discussion of limited partnership associations is beyond the scope of this article, anyone seeking corporate tax treatment for professionals in Ohio should at least weigh the possible uses. For an excellent discussion of the use of limited partnership association see E. R. Schwartz, *Limited Partnership Association — An Alternative to the Corporation for the Small Business with "Control" Problems?*, 20 RUTGERS L. REV. 29 (1965). See also, *Giant Auto Parts, Ltd.*, 13 T.C. 307 (1949).

⁵ OHIO REV. CODE ANN. § 1785 (Page 1964).

statutes in several other mid-western states, in an effort to describe some of the non-tax aspects of the formation and operation of professional associations, while at the same time pointing out, and hopefully supplying some constructive suggestions toward curing, some of the major deficiencies in the Ohio statute. This latter point is particularly important, for, if the underlying premise of this article is correct, many professional associations are going to be formed, operated, and dissolved during the next few years. The Ohio legislature appears to have within its reach a unique opportunity to head off a myriad of unnecessary legal problems caused by troublesome statutory language. Unless it grasps this opportunity now, professional associations and their officers, directors, and shareholders may find themselves confronted with unnecessary and uneconomical problems for many years.

II. FEDERAL TAX BACKGROUND

The Ohio professional association statute has a history starting long before its adoption in 1961. For the most part, this history consists of a protracted disagreement between the United States Treasury Department and various groups of taxpayers over the meaning of the terms "corporation" and "association."⁶ The Internal Revenue Code has shed little light on this dispute, for it simply provides that "The term 'corporation' includes associations, joint-stock companies, and insurance companies."⁷

The modern phase of this history probably began in 1935 when the United States Supreme Court in *Morrissey v. Commissioner*⁸ held that an unincorporated trust was an "association" taxable as a corporation because of its resemblance to a corporation. In arriving at its conclusion, the Court concluded that a corporation had certain characteristics against which an unincorporated entity could be measured to determine whether it more nearly resembled a corporation than a partnership or trust.⁹ A corporation as well as a partnership has associates, and an object to carry on business and divide the gains. A corporation, unlike a partnership, also has centralized management, continuity of existence, free transferability of interest, and limited liability. Following *Morrissey*, the Treasury Department began to use the "resemblance test" to determine whether an unin-

⁶ See, B. Eaton, *Professional Corporations and Associations in Perspective*, 23 TAX L. REV. 1 (1967). See also, B. Bittker, *Professional Service Organizations: A Critique of the Literature*, 23 TAX L. REV. 429 (1968) (this article contains a bibliography of the major articles on the income tax treatment of professional corporations). A comment on Professor Bittker's article is contained in 24 TAX L. REV. 291 (1969) and Professor Bittker's reply is contained in 24 TAX L. REV. 300 (1969).

⁷ INT. REV. CODE OF 1954, §7701 (a) (3).

⁸ 296 U.S. 344 (1935).

⁹ *Id.* at 357: "The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts."

corporated organization should be taxed as a partnership, trust, or corporation.¹⁰

For years many taxpayers wanted corporate characteristics, such as limited liability, but did not want to be treated as corporations for federal income tax purposes.¹¹ During and shortly after World War II, however, one large group of taxpayers, roughly characterized as "professionals," began to conclude that corporate tax statutes might offer certain advantages. It was during this period that individual tax rates were increased, and qualified pension and profit-sharing plans came into vogue.¹²

In the midst of this shifting of positions, in 1954 the 9th Circuit Court of Appeals in *United States v. Kintner*,¹³ held that an unincorporated group of Montana doctors was an "association" taxable as a corporation. This result was reached even though corporations were not permitted to practice medicine in Montana and the association was probably a partnership under Montana law. The court rejected the Commissioner's argument that it should look to local law to determine the classification of the organization, and pointed out that the Commissioner's own regulations also rejected such an approach.¹⁴

In 1960, after losing one more case,¹⁵ the Treasury Department issued the now famous "Kintner Regulations"¹⁶ in an effort to overcome the *Kintner* loss. In addition to requiring that an entity have a majority of corporate characteristics to be taxed as a corporation, the Regulations also referred to local law:

Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.¹⁷

This emphasis on local law represented a substantial shift in the government's pre-*Kintner* position and led or at least contributed to the enactment of professional corporation statutes by the states.¹⁸ The states were quite willing to make the necessary "local law." Today, more than thirty

¹⁰ See Minn. 4483, XV-2 CUM. BULL. 175 (1936); B. Eaton, note 6 *supra*, at 5.

¹¹ The taxpayer in *Morrissey* exhibited this desire.

¹² See B. Eaton, note 6 *supra*, at 6.

¹³ 216 F. 2d 418 (9th Cir. 1954).

¹⁴ *Id.* at 423.

¹⁵ *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959).

¹⁶ Treas. Reg. §301.7701-1 to -11, 1960-2 CUM. BULL. 409.

¹⁷ Treas. Reg. §301.7701-1(c), 1920-2 CUM. BULL. 409, 413.

¹⁸ See B. Eaton, note 6 *supra*, at 8.

states, including Ohio, have some form of professional association or professional corporation statute.¹⁹

After several more years of conflict, and after losing at least one case,²⁰ the Treasury Department responded to the professional corporation statutes by issuing the present Regulations.²¹ For more than a decade, the Treasury Department had attempted to classify all types of unincorporated organizations by applying one test: the test of corporate resemblance, with or without local law. Now, for the first time, it attempted to expand its approach by applying two tests.²² The general tests were continued for most corporations, but new tests were established for professional service organizations.²³ In general, the Treasury Department took the position that regardless of whether or not a professional service organization was incorporated under state law, it was inherently different from other corporations and deserved separate and different treatment. The different treatment offered is such that few, if any, professional service organizations could be classified as corporations for federal tax purposes.

Today the professional service Regulations appear to be near their end. In case after case the courts have determined that they are invalid as representing an unauthorized exercise of legislative authority by the Treasury Department.²⁴ Regardless of the ultimate disposition of these cases on appeal, it appears that the professional service Regulations have a very dim future.

III. PROFESSIONAL ASSOCIATION AND PROFESSIONAL CORPORATION STATUTES

The statutes in Ohio²⁵ and the adjoining states of Michigan,²⁶ Pennsylvania,²⁷ Kentucky,²⁸ and Indiana²⁹ employ at least two different patterns. They are either self-contained,³⁰ they set forth in very brief fashion all of the operative rules, or they are open-ended,³¹ they set forth a few rules and then incorporate by reference that portion of the general corporation statute which is not inconsistent with the professional corporation statute.

¹⁹ 6 CCH 1969 STAND. FED. TAX REP. II 5943.1973.

²⁰ *Foreman v. United States*, 232 F. Supp. 134 (S.D. Fla. 1964).

²¹ Treas. Reg. §301.7701-1 and -2 (1965).

²² In 1918 there was a distinction made between regular corporations and "personal service corporations." For a brief period the latter was taxed as a partnership. *Eaton*, note 6 *supra*, at 2.

²³ Treas. Reg. §301-7701-2 (h) (1965).

²⁴ See, e.g., *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969).

²⁵ OHIO REV. CODE ANN. § 1785 (Page 1964).

²⁶ MICH. COMP. LAWS §§ 450.221 — 450.235 (1964).

²⁷ PA. STAT. ANN. tit. 15, §§ 12601 — 12619 (1962).

²⁸ KY. REV. STAT. ANN. §§ 247.015 — 274.990 (1963).

²⁹ IND. ANN. STAT. §§ 25-4901 — 25-4921 (19—) (medical professional corporations).

³⁰ See, e.g., PA. STAT. ANN. tit. 15, §§ 12601 — 12619 (1962).

³¹ See, e.g., OHIO REV. CODE ANN. § 1785.08 (Page 1964).

In addition, some of the statutes³² refer to the entity created thereunder as a "corporation" while others,³³ including Ohio,³⁴ refer to it as an "association." One other major variation is that in some states,³⁵ including Ohio,³⁶ all professions are included within one statute, whereas in other states³⁷ some professions have separate statutes.

While the state legislatures were willing to make "local law" to help preserve the revenue of their citizens, they were not willing to grant to the professional corporation all of the characteristics of a general corporation.³⁸ Most states, including Ohio,³⁹ had a long tradition of preventing corporations from providing professional services. Although the professional corporation statutes represented a substantial alteration in that tradition, the alteration was subject to numerous restrictions presumably intended to protect the public against the possibility of having unlicensed persons provide professional services, either indirectly by controlling professional corporations as shareholders or directors, or directly as employees of professional corporations. The restrictions may also have been intended to protect the professional shareholder against the stigma which might attach to professional corporations if they were used by unlicensed and unqualified persons to provide improper professional services.

In addition to placing narrow limits on the purposes for which a professional corporation may be formed, most of the statutes also impose qualification requirements on the incorporators, shareholders, directors, and officers, and, in some cases, require the professional corporation to use a designation which will differentiate it from a general corporation. In an effort to enforce the statutory requirements, most of the statutes require the professional corporation to file an annual report with a state agency.

The one common thread which runs throughout all of the statutes is a legislative policy of preventing professional corporations from being used by non-professionals to provide services which the non-professionals would not otherwise be authorized to provide.

IV. THE OHIO PROFESSIONAL ASSOCIATION STATUTE: PROBLEMS AND SOME POSSIBLE SOLUTIONS

From the first steps of selecting incorporators and determining the corporate purpose through the last steps of providing for the death or retire-

³² See, e.g., MICH. COMP. LAWS § 450.222(b) (1964).

³³ See, e.g., PA. STAT. ANN. tit 15, § 12602 (1962).

³⁴ OHIO REV. CODE ANN. § 1785.01 (B) (Page 1964).

³⁵ See, e.g., MICH. COMP. LAWS § 450.222 (1964).

³⁶ OHIO REV. CODE ANN. § 1785.01 (A) (Page 1964).

³⁷ See, e.g., IND. ANN. STAT. §§ 25-4901 — 25-9421 (1964) Medical Professional Corporations).

³⁸ See B. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961).

³⁹ See, OHIO REV. CODE ANN. § 1701.03 (Page 1964).

ment of a shareholder, the Ohio professional association statute is permeated with difficult interpretive problems. With few exceptions, these problems are created by the restrictions and qualifications which are imposed upon the professional association and its shareholders, directors, and officers.

A. Selecting and Retaining Incorporators, Directors, and Officers

One of the very first, and certainly one of the most perfunctory acts in the formation of a corporation is the selection of incorporators. As in the case of a general corporation, at least three incorporators are required to form a professional association.⁴⁰

The following provision might be interpreted to require the three incorporators to be licensed to practice the profession for which the corporation is formed: "An individual or group of individuals each of whom is licensed . . . to render the same kind of professional service within this state may organize and become a shareholder, or shareholders, of a professional association."⁴¹ However, since that provision also authorizes the formation of a one shareholder corporation, it is hard to believe that the legislature intended to require the one shareholder to find two other licensed professionals⁴² to serve as incorporators. It is more reasonable to believe that the selection of incorporators in Ohio is so routine that the legislature never considered them at all and consequently, when it placed restrictions on the persons who could "organize" a professional association it did not thereby intend to place restrictions on the incorporators who could "form" the corporation.⁴³

If the Ohio statute is interpreted to require all incorporators to be licensed professionals, then the requirement of three incorporators is a substantial burden for a one or two shareholder professional association. Most of this burden will be removed if Substitute Senate Bill Number 158, which is presently before the Ohio legislature, is adopted, for it would reduce the required number of incorporators from three to one. However, to remove the remaining uncertainty, it would be appropriate for the legislature to either require the one incorporator to be a licensed professional or to specifically negate that requirement.

Of more substantive concern are the requirements with respect to directors, for under Ohio law the directors exercise all of the authority of the

⁴⁰ OHIO REV. CODE ANN. § 1785.08 and § 1701.04 (Page 1964).

⁴¹ OHIO REV. CODE ANN. § 1785.02 (Page 1964).

⁴² "Licensed professionals" is used in this article for the sake of brevity. In fact, the person must be "licensed or otherwise legally authorized" to render the same kind of professional service that the professional association is authorized to render.

⁴³ But see, Vesely, *Professional Associations*, 13 CASE W. RES. L. REV. 195, 198 (1962). Is the term "organize" as used in OHIO REV. CODE ANN. § 1785.02 (Page 1964) intended to be broader than the term "form" in § 1701.03 (Page 1964)?

corporation not otherwise reserved to the shareholders.⁴⁴ The statute requires the persons who provide professional services on behalf of the association to be licensed professionals.⁴⁵ It also requires the shareholders to be licensed professionals.⁴⁶ However, as anomalous as it may seem, there is no requirement that the directors, as such, be licensed professionals.⁴⁷

The use of non-licensed directors would not be permitted in most of the surrounding states.⁴⁸ In addition, for some professions the use of non-licensed directors would represent a violation of ethical standards.⁴⁹ Furthermore, such a use might violate some professional licensing statutes, if not in Ohio, then in adjoining states.⁵⁰

Once the shareholders of a professional association conclude that they will use licensed professionals as directors, they are, in the case of the one or two shareholder association, faced with the difficult problem of finding other licensed professionals to serve as directors, since the corporation must have at least three directors.⁵¹ Given the highly publicized liability exposure of directors of general corporations,⁵² and the uncertainty surrounding professional associations, this could present an insurmountable problem for some professional associations. However, this problem will no longer exist if Substitute Senate Bill Number 158 is passed, for it would reduce the required number of directors to the number of shareholders in a one or two shareholder corporation.

If a director is not, in the first instance, required to be a licensed professional, it follows that he need not cease to be a director if he loses his license. Thus, but for ethical standards, or possibly professional licensing requirements, a corporation authorized to practice law (if such a corporation may be formed in the future)⁵³ may continue to have on its board of directors a disbarred attorney or a medical corporation may continue to have on its board of directors a physician who has lost his license. Moreover, a corporation could provide medical services, again subject to ethical standards and professional licensing requirements, even though all of its directors have lost their licenses, provided that it employs licensed persons to carry out its professional activities.

⁴⁴ OHIO REV. CODE ANN. § 1701.59 (Page Supp. 1968).

⁴⁵ OHIO REV. CODE ANN. § 1785.03 (Page 1964).

⁴⁶ OHIO REV. CODE ANN. § 1785.02, § 1785.06, and § 1785.07 (Page 1964).

⁴⁷ See Vesely, note 43 *supra*, at 202.

⁴⁸ See, e.g., KY. REV. STAT. ANN. § 274.035 (1963).

⁴⁹ ABA FORMAL OPINION 303 (1961).

⁵⁰ See, e.g., MICH. COMP. LAWS § 338.567 (1964).

⁵¹ OHIO REV. CODE ANN. § 1701.56(A) (Page 1964).

⁵² "General corporations" refers to corporations formed under OHIO REV. CODE ANN. § 1701 (Page 1964).

⁵³ At the present time Ohio attorneys may not use professional associations. *State ex rel. Green v. Brown*, 173 Ohio St. 114, 180 N.E.2d 157 (1962).

This problem is solved in Kentucky by the following provision:

No person may be [a] . . . director . . . unless he is and remains duly licensed and free from legal disability to render the professional services for which the corporation was organized.⁵⁴

A similar requirement seems to be imposed in Michigan⁵⁵ by the more indirect means of requiring all directors to be shareholders and all shareholders to be licensed. Indiana carries the Kentucky pattern even further by not only requiring a director who loses his license to sever his connection with the corporation,⁵⁶ but also requiring the corporation to force compliance with that provision or face the loss of its charter.⁵⁷

It appears that officers who do not perform professional services on behalf of the association need not be licensed professionals.⁵⁸ Since most corporate officers do not possess the broad corporate authority of directors, permitting the use of some unlicensed officers does not pose a threat to the legislative policy underlying the licensing requirements.

Many of the problems with respect to incorporators and directors can be solved by the adoption of Substitute Senate Bill Number 158, which would reduce the number of incorporators to one and reduce to one and two, respectively, the number of directors required in one and two shareholder corporations. Many of the remaining problems can be solved by requiring, as in Kentucky,⁵⁹ that all directors be and remain licensed, and by establishing, as in Indiana,⁶⁰ mechanics for implementation of the legislative policy. This would prevent unlicensed persons from serving on the board of directors and possibly controlling a professional association and would buttress the legislative policy which is expressed by the requirement that officers and employees who provide professional services and all shareholders be licensed.

On the other hand, there are good reasons to continue to permit unlicensed persons to hold some offices so long as they are not shareholders or directors and do not provide professional services. This would permit the engineering corporation to elect its internal accountant as treasurer or its house counsel as secretary. However, it would be consistent with the overall policy of the statute to add a requirement that any officer who is authorized to supervise or control the professional activities of a person who is a licensed professional must also be a licensed professional.⁶¹ This would

⁵⁴ KY. REV. STAT. ANN. § 274.035 (1963).

⁵⁵ MICH. COMP. LAWS § 450.232 and § 450.222(b) (1964).

⁵⁶ IND. ANN. STAT. § 25-4917 (1964) (medical professional corporation).

⁵⁷ *Id.*

⁵⁸ See Vesely, *supra* note 53, at 202. It is not inconceivable that a court might construe OHIO REV. CODE ANN. § 1785.03 (Page 1964) to require all officers to be licensed professionals.

⁵⁹ KY. REV. STAT. ANN. § 274.035 (1963).

⁶⁰ IND. ANN. STAT. § 25-4917 (1964) (medical professional corporation).

⁶¹ It is possible to interpret OHIO REV. CODE ANN. § 1785.03 (Page 1964) as already imposing such a requirement.

make it clear that the chief executive officer of a professional association must be a licensed professional even though he does not directly provide any professional services.

Finally, one unnecessary problem can be eliminated by requiring the one incorporator to be a licensed professional or providing specifically that he need not be a licensed professional, the latter being the more practical choice.

B. *Scope of Activities*

A professional association may only be formed for the *sole* purpose of rendering a professional service.⁶² Its shareholders must be licensed or otherwise legally authorized to render the same kind of professional service.⁶³

The "one profession" limitation seems to be a fundamental part of the professional corporation concept.⁶⁴ For many professions this requirement echoes the ethical standards or professional licensing requirements otherwise applicable to a group practice.⁶⁵

One might question the advisability of trying to superimpose ethical standards on professionals via a professional association statute. Nevertheless, it must be recognized that this approach is fundamental in most such statutes, and is not likely to be changed.⁶⁶

In addition to only providing one professional service, the professional association may not engage in unrelated activities: its "sole purpose" must be to render the professional service. This, of course, raises a number of questions about the manner in which the professional association utilizes its funds. May the three shareholder medical association purchase land and build a one-story office building? May it build a ten-story office building if it only uses one-half of one floor? May it invest its excess funds in raw land or in an apartment project?

The general corporation statute gives the professional association very broad powers in carrying out the purposes stated in its articles.⁶⁷ However, since the purpose of a professional association must be limited to rendering a professional service, it is not clear what activities the association may prop-

⁶² OHIO REV. CODE ANN. § 1785.01 (B) (Page 1964).

⁶³ OHIO REV. CODE ANN. § 1785.02 (Page 1964) [immediately prior to publication § 178.01 and 1785.02 were amended to permit architects and professional engineers to join in professional associations.]

⁶⁴ See, e.g., MICH. COMP. LAWS § 450.222 (1964).

⁶⁵ See, e.g., OHIO REV. CODE ANN. § 4703.18(D) (Page Supp. 1968) [immediately prior to publication this section was amended effective Sept. 23, 1969.]

⁶⁶ Some states have made an exception to the "one profession" limitation by permitting architects and engineers to be shareholders in the same corporation. See, e.g., § 5 of the Washington Professional Service Corporation Act, 7 CCH 1969 STAND. FED. TAX REP. II 6628, which becomes effective on June 12, 1969 [Ohio added a similar provision to its statute by Amended Senate Bill 330.]

⁶⁷ OHIO REV. CODE ANN. § 1701.13 (F) (Page Supp. 1968).

erly undertake outside of those activities which specifically relate to rendering the professional service.⁶⁸

The statutes in some other states contain language which specifically authorize the professional corporation to invest its funds in certain kinds of assets. For instance, the Kentucky statute contains the following language:

No professional service corporation organized under this chapter shall engage in any business other than the rendering of the professional service for which it was specifically incorporated; provided, however, that nothing in this chapter or any other provisions of existing law applicable to corporations shall be interpreted to prohibit such corporations from investing its funds in real estate, mortgages, stocks, bonds, or any other type of investment, or from owning real or personal property necessary for the rendering of professional services.⁶⁹

The original Ohio professional association bill contained language very much like this but it was deleted prior to enactment.⁷⁰

While the language in the Kentucky statute is not ideal, it at least answers the questions about investments in real estate, improved or unimproved, and provides the professional corporation with some workable ground rules.

The Ohio statute should be revised to expressly permit the professional association to make unrelated investments.

C. *Limited Liability*

In a professional partnership, the partnership is liable for any wrongful act or omission of any partner acting in the ordinary course of the partnership's business or with the authority of his partners⁷¹ and the partners are jointly and severally liable for such obligations of the partnership.⁷² In a general corporation, an employee is personally liable for his own negligent acts or omissions⁷³ and the corporation is frequently also liable for the negligence of its employees,⁷⁴ but a shareholder, as such, is not personally liable for the obligations of the corporation.

Only one section of the professional association statute refers to the liability of anyone. Section 1785.04 provides:

Sections 1785.01 to 1785.08, inclusive, of the Revised Code, do not modify any law applicable to the relationship between a person furnishing professional services and a person receiving such services, including liability arising out of such professional service.⁷⁵

⁶⁸ See Vesely, note 43 *supra*, at 197.

⁶⁹ KY. REV. STAT. ANN. § 274.115 (1963).

⁷⁰ Dunkel, *Professional Corporations*, 22 OHIO S. L. J. 703, 709 (1961).

⁷¹ OHIO REV. CODE ANN. § 1775.12 (Page 1964).

⁷² OHIO REV. CODE ANN. § 1775.14 (Page 1964).

⁷³ See, RESTATEMENT (SECOND) OF AGENCY § 343 (1958).

⁷⁴ See W. PROSSER, TORTS 470 (3rd ed. 1964).

⁷⁵ OHIO REV. CODE ANN. § 1785.04 (Page 1964).

The meaning of that language which appears in the statutes of several states,⁷⁶ has been subject to vigorous debate. Professor Bittker in an early article on professional corporations raised the possibility that "person furnishing professional services" might be interpreted broadly to encompass all of the members or shareholders, with the result that the mutual agency and resulting mutual liability of partnership law would be applied.⁷⁷ Other commentators seem to have concluded that it merely restates the general rule that a corporate employee is liable for his own negligent acts.⁷⁸ Still other commentators have reached intermediate conclusions between these two extremes.⁷⁹ One such intermediate conclusion is that this language preserves "such forms of personal liability as a physician's vicarious liability for the negligence of assistants under his control and the professional's contract liability for failure to provide a promised result."⁸⁰ Still another suggestion is that the language might result in personal liability to all persons who participate in furnishing services out of which the tort arises.⁸¹

The federal district court in *O'Neill*⁸² considered this issue and the conclusions of commentators on both sides, although not the commentators in between, and concluded that "the shareholders of Ohio professional associations have limited liability."⁸³ This seems to be a sound conclusion if it means that shareholders, as shareholders, have limited liability. However, the court's reasoning does not necessarily lead to the conclusion that a shareholder-employee of a professional association has the same immunity from liability that he would have in a general corporation.⁸⁴

There is no mandatory requirement, legal or ethical that professionals must always subject themselves to personal liability for the acts of their colleagues. For years it has been possible for professionals to receive corporate-type liability protection by forming an Ohio limited partnership association.⁸⁵ This entity has the same general liability features as a general corporation.⁸⁶ In addition, there is nothing inherently unethical or im-

⁷⁶ See, e.g., IND. ANN. STAT. § 25-5109 (1964) (professional corporations).

⁷⁷ B. Bittker, note 38 *supra*, at 11.

⁷⁸ Vesely, note 43 *supra*, at 203.

⁷⁹ 75 HARV. L. REV. 776 (1962).

⁸⁰ *Id.*, at 781.

⁸¹ *Id.*

⁸² *O'Neill v. United States*, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd.* ___ F.2d ___ (6th Cir. 1969).

⁸³ *Id.*, at 362.

⁸⁴ "Since it is inconceivable that a professional-association statute would be taken to repeal the professional practitioner's common law liability for torts he personally commits, the qualification is mere supererogation unless it saves more than that liability." 75 HARV. L. REV. 776, 781 (1962).

⁸⁵ OHIO REV. CODE ANN. § 1783 (Page 1964).

⁸⁶ OHIO REV. CODE ANN. § 1783.08 (Page 1964).

proper about limiting professional liability, provided that the client is placed on notice that he is dealing with a corporate entity.⁸⁷

Most of the statutes in the states surrounding Ohio contain language similar to that found in the Ohio statute. However, the Michigan statute contains some interesting additional language:

Any officer, shareholder, agent or employee of a corporation organized under this act shall remain personally and fully liable and accountable for any negligent or wrongful act or misconduct committed by him, or by any person under his direct supervision and control, while rendering professional service on behalf of the corporation to the person for whom such professional services were being rendered.⁸⁸

This language makes explicit one conclusion reached by the intermediate interpreters of the Ohio-type statute.⁸⁹

Certainly the Ohio legislature should clarify the language of Section 1785.04 before the litigation starts. The *O'Neill* conclusion is far too narrow to provide any comfort. If the intermediate interpretation is the one which the Ohio legislature intended, and it does offer an interesting reconciliation of the desire to have general corporation limited liability while protecting the professional-client relationship, then it should be clearly expressed in the statute. In any event, and regardless of the intended result, the shareholder-employee must be put in notice of the extent of his personal liability exposure.

D. *Selection of Name*

Since the Ohio professional association statute says nothing about the name to be used, the professional association must follow the general corporate statute which requires its name to end with or include "Company," "Co.," "Corporation," "Incorporated," or "Inc."⁹⁰ In addition, the professional association must comply with any ethical or licensing requirements with respect to the use of individual names.⁹¹

Other states either permit the professional corporation to select any name permitted by law or the ethics of the profession,⁹² or require the use of words which distinguish the professional corporation from other corporations.⁹³ Kentucky and Michigan are both in the latter category. Ken-

⁸⁷ See ABA FORMAL OPINION 303 (1961).

⁸⁸ MICH. COMP. LAWS § 430.226 (1964).

⁸⁹ It may have even carried this conclusion one step further. Does the Michigan Statute mean that a non-shareholder employee is liable for any negligence of a person under his direct supervision and control? See, *Kurzner v. United States*, 286 F. Supp. 839, 845 (S.D. Fla. 1968) *aff'd*, ___ F.2d ___ (5th Cir. 1969).

⁹⁰ OHIO REV. CODE ANN. § 1701.04 (A) (1) (Page 1964).

⁹¹ See, e.g., OHIO REV. CODE ANN. § 4715.18 (Page Supp. 1968). See Vesely, note 43 *supra*, at 199.

⁹² See, e.g., PA. STAT. ANN. § 12615 (1962).

⁹³ See, e.g., MICH. LAWS § 450.231 (1964).

tucky⁹⁴ requires the use of "chartered," "professional service corporation," or "P.S.C." and Michigan⁹⁵ requires the use of "professional corporation" or "P.C."

Since there are fundamental differences between a professional association and a general corporation, the requirement that a professional association identify itself by the words "professional association" or by the initials "P.A.," may serve some useful purposes. It will put the public on notice that it may have limited authority outside of the area of its practice. It will also provide the public with assurances that its shareholders are licensed professionals. Moreover, it may offer certain non-legal, psychological benefits to the traditionalists who frown on adding "Inc." to their name.

E. *Transfer of Shares: Voluntary and Involuntary*

A professional association may only issue its shares to persons who are licensed to provide the same professional service that the association is authorized to provide.⁹⁶ Once a person becomes a shareholder, he may only transfer his shares to an individual who is also licensed to provide the same professional service.⁹⁷ A shareholder may not transfer his stock to his children, unless they are licensed to provide the same professional service, or to a trustee of a trust. Also, he may not transfer his shares to another corporation.

May the professional association purchase or redeem his shares? The professional association statute is strangely silent on this point, with the result that one must try to reconcile the statement in the professional association statute that a shareholder may only "sell or transfer his shares . . . to another individual who is duly licensed. . . ."⁹⁸ with the provisions of the general corporate statute authorizing a corporation to purchase⁹⁹ or redeem¹⁰⁰ its own stock. A literal reading of the professional association statute would lead one to conclude that the professional association cannot purchase or redeem its own shares.¹⁰¹ However, this results in such a myriad of problems that a court might feel compelled to find that a redemption of the shares is not a "sale or transfer" or that the professional association section dealing with transfers is simply not intended to deal with redemptions and purchases by the issuing association. In any event, until this problem is clarified, the shareholders of a professional association

⁹⁴ KY. REV. STAT. ANN. § 274.075 (1963).

⁹⁵ MICH. COMP. LAWS § 450.231 (1964).

⁹⁶ OHIO REV. CODE ANN. § 1785.05 (Page 1964).

⁹⁷ OHIO REV. CODE ANN. § 1785.07 (Page 1964).

⁹⁸ *Id.*

⁹⁹ OHIO REV. CODE ANN. § 1701.35 (Page Supp. 1968).

¹⁰⁰ OHIO REV. CODE ANN. § 1701.23 (Page 1964).

¹⁰¹ See, Z. CAVITCH, OHIO CORPORATION LAW § 1824 (1968).

should attempt to avoid this problem by providing in the articles of incorporation that the association may redeem or purchase its own shares and by entering into a buy-sell agreement pursuant to which the association or the other shareholders are authorized to purchase a shareholder's stock in certain events, i.e. death, disability, bankruptcy, and loss of license. If the buy-sell agreement provides for the purchase of a shareholder's stock by the association, it also ought to provide for a purchase by the other shareholders if the association is prevented by law from purchasing the shares.

Of course, it makes little sense to continue in force, without change, a statute that requires a judicial interpretation to reach a result that is almost necessitated by its other requirements. Ohio should follow the pattern of other states, and specifically permit the professional association to purchase or redeem its shares.¹⁰²

While the statute presents a number of problems for voluntary transfers, at least the shareholder can refrain from making the transfers. However, there are a number of circumstances in which transfers must be made, such as the death or disqualification of a shareholder. The statute's silence on these points raises serious problems.

If the shareholder can only transfer his shares to another individual licensed to engage in the same profession, what happens when he dies or becomes incompetent? Here one may ask an infinite variety of questions and arrive at no answers other than to speculate about the probable result of litigation which is sure to occur. A brief list of some questions should illustrate this point. In each case assume that no buy-sell agreement exists; that the remaining shareholders and the family of the deceased shareholder have a strained relationship; and, to make the illustration as graphic as possible, that the deceased shareholder owned 51% of the outstanding common stock.

- (i) If the executor of the deceased shareholder's estate requests the corporation to transfer the shares to his name, should the corporation honor his request?
- (ii) What happens if the executor and corporation cannot agree upon a purchase price for the shares?
- (iii) Even if they can agree on a price, can the corporation properly purchase the shares?
- (iv) Must the executor be given notice of shareholders' meetings?
- (v) May he vote at the meetings?
- (vi) Is he entitled to receive dividends on the shares?

Other states have tried to answer these questions by employing a number of different statutory schemes; some quite simple, others quite elaborate. Michigan takes the most direct and relatively simple approach.

No shares of a corporation organized under this act shall be sold or transferred except to an individual who is eligible to be a shareholder of such

¹⁰² See, e.g., MICH COMP. LAWS § 450.230 (1964).

corporation or to the personal representative or estate of a deceased or legally incompetent shareholder. The personal representative or estate of such shareholder may continue to own such shares for a reasonable period but shall not be authorized to participate in any decisions concerning the rendering of professional service. The articles of incorporation or bylaws may provide specifically for additional restrictions on the transfer of shares and may provide for the redemption or purchase of such shares by the corporation or its shareholders at prices and in a manner specifically set forth. The provisions dealing with the purchase or redemption by the corporation of its shares may not be invoked at a time or in a manner that would impair the capital of the corporation.¹⁰³

This provision certainly answers a number of questions, although it is vague about the right of the executor to vote at shareholders' meetings, particularly with respect to the election of directors, and it does not establish procedures for handling the situation where the parties are unable to agree on a price.

The Indiana statute does not seem to deal adequately with the role of the executor prior to the sale, but, if the parties have not otherwise agreed upon a sales procedure, it requires a sale at book value within 90 days after the shareholder's death.¹⁰⁴ While this provides great simplicity and certainty, book value is highly arbitrary and seldom reflects market value in a personal service enterprise.¹⁰⁵

The Kentucky statute establishes a very elaborate procedure that requires the parties to bring an equitable action for a determination of the fair market value of the shares if they are otherwise unable to agree.¹⁰⁶ It also sets up an appraisal procedure. It insures compliance by providing for loss of the corporate charter if the parties are unable to agree and the corporation fails to bring the equitable action.¹⁰⁷

Ohio might well borrow some statutory language from the adjoining states, and improve on it a bit, to head off the many problems associated with the death or incompetency of a shareholder. Like Michigan,¹⁰⁸ Ohio should have a provision giving to the personal representative of the deceased or incompetent shareholder an interim status. It would be best to treat the personal representative as a passive investor, much like a non-voting preferred shareholder or a limited partner, during the interim period. He should not be permitted to vote for directors or on routine matters but he should be entitled to receive notice of shareholder meetings and to vote on those fundamental changes in the corporate structure which affect his investment, such as a merger.

¹⁰³ *Id.*

¹⁰⁴ IND. ANN. STAT. § 25-4918 (19—) (medical professional corporation).

¹⁰⁵ *Cf.*, Rev Rule 59-60, 1959-1 Cum. Bull. 237.

¹⁰⁶ KY. REV. STAT. ANN. § 274.095 (Supp. 1968).

¹⁰⁷ *Id.*

¹⁰⁸ MICH. COMP. LAWS § 450.230 (1964).

Then, like Kentucky,¹⁰⁹ a time limit might be established for the sale to take place. The parties might be permitted to voluntarily extend the time limit by two or three years, so that, in an appropriate case, the deceased shareholder's estate could delay the sale until after the value of the stock is determined for Ohio or federal estate tax purposes. Since the personal representative would be treated as a passive investor, an extension by agreement would not unduly conflict with the policy of prohibiting non-licensed persons from being shareholders.¹¹⁰

If the parties were unable to agree upon the terms of sale within the prescribed time, then a modified Kentucky procedure should be applied. The parties should be required to go to court, but, unlike Kentucky, where the court appoints an appraiser,¹¹¹ the parties should be required to use an arbitration-type technique of each appointing an appraiser, and having the two appraisers appoint a third appraiser. If the two appraisers could not agree on the selection of a third appraiser or if other disagreements should arise, then the court could intervene and appoint a third appraiser or resolve the dispute. If any two of the three appraisers could agree on a price, their determination would be binding on the parties. If they could not agree, then the determination of the third appraiser would be binding on the parties. To aid this procedure, the statute might establish certain fundamental valuation principles to give the appraisers some frame of reference.

Finally, like Kentucky,¹¹² Ohio should impose sanctions, so if the parties are unable to agree, the corporation will be required, at the risk of losing its charter, to bring the appropriate action.

Many of the same problems arise when a shareholder loses his license. Unlike the statutes in some other states,¹¹³ the Ohio professional association statute does not expressly require each shareholder to continue to be licensed nor does it establish any procedure by which he is to divest himself of his shares. The only section of the statute which seems to deal with this problem is the section which requires the president and secretary of the professional association to file a report each year with the Ohio Secretary of State in which they certify that all shareholders are "duly licensed or otherwise legally authorized" to provide professional services in Ohio.¹¹⁴ Since nothing is said about the consequences of not filing the report, presumably nothing will happen unless the state or one of the as-

¹⁰⁹ KY. REV. STAT. ANN. § 274.095 (Supp. 1968).

¹¹⁰ It might raise some fee-splitting problems, but this will always be true for some period of time in a professional association.

¹¹¹ KY. REV. STAT. ANN. § 274.095 (Supp. 1968).

¹¹² *Id.*

¹¹³ See, e.g., KY. REV. STAT. ANN. § 274.035 (1963).

¹¹⁴ OHIO REV. CODE ANN. § 1785.06 (Page 1964).

sociation's shareholders or directors institutes a lawsuit.¹¹⁵ Then, of course, the court would be faced with solving the same type of problem posed by the death or incompetency of a shareholder, with little if any legislative guidance.

Most other states have tried to solve this problem by applying the same rules to a shareholder disqualification as to his death.¹¹⁶ Ohio could also take this approach, although it should substantially reduce the time limit within which the parties are required to agree upon the terms of sale. In a probate setting a substantial time period may be desirable for tax and administrative reasons; but when a shareholder loses his license, there should be a desire on the part of all of the parties to sever the relationship as promptly as possible.

F. *One Shareholder Associations*

The limitations imposed upon the identify of the transferee¹¹⁷ by most professional association and professional corporation statutes, raise a particularly difficult problem for the one shareholder corporation. What happens to an Ohio professional association when its only shareholder dies? One might conclude that it must be dissolved.¹¹⁸ If this is so, and at least one state¹¹⁹ specifically requires this result, then it would seem that a one shareholder Ohio professional association would not have the corporate characteristic of "continuity of life" even as that characteristic is defined in the portion of the Regulations applied to non-professional corporations.¹²⁰ Moreover, depending upon the size of the organization and of its board of directors, it may or may not have the other corporate characteristics of centralized management, limited liability, and free transferability of interest.¹²¹

The extreme example of a professional association which would seem not to meet even the non-professional corporation Regulations would be a medical corporation which has one shareholder and one director, both the same person,¹²² and no other professional employees. Such a professional association may not be treated as a corporation for tax purposes even if

¹¹⁵ See, OHIO REV. CODE ANN. § 1701.13 (H) (Page Supp. 1968).

¹¹⁶ See, e.g., KY. REV. STAT. ANN. § 274.095 (Supp. 1968).

¹¹⁷ See, e.g., OHIO REV. CODE ANN. § 1785.07 (Page 1964).

¹¹⁸ There are also a number of other possibilities. The executor might be authorized to amend the articles of incorporation to convert the professional association into a general corporation. Alternatively, the professional association might simply be required to suspend its professional activities until such time as the shares are transferred to a licensed person. See, Vesely, *supra* note 43, at 201.

¹¹⁹ KY. REV. STAT. ANN. § 274.095 (3) (Supp. 1968).

¹²⁰ Treas. Reg. § 301-7701-2(b) (1965).

¹²¹ Cf., B. Bittker, note 6 *supra*, at 440.

¹²² This assumes that substitute Senate Bill No. 158 is adopted.

the Treasury Department withdraws its professional corporation Regulations.¹²³

Aside from the federal income tax considerations, the statute's silence as to the consequence of the death of a sole shareholder presents a substantive corporate problem which should be solved. One way to solve this problem is to authorize the personal representative of the deceased shareholder to continue to hold the shares for a limited period of time as a "passive investor" and to elect licensed professional persons as directors. The personal representative would then be permitted to sell the shares to a licensed professional during a given period of time or, if no such sale was made, to dissolve the association. In addition to solving a substantive corporate problem, this might also provide at least a modified form of continuity of life for income tax purposes.

G. *Enforcement Policy*

There is no explicit procedure established in the professional association statute for enforcing the annual report requirement. Since it is, or at least could be, the key to carrying out the legislative policy of regulating the qualification of shareholders, the reporting requirement should be expanded and made enforceable. It should be expanded by requiring a certification that all of the persons required to be licensed are in fact licensed. This would cover not only shareholders, but also directors and those officers who are required to be licensed. Failure over an extended period of time to comply with the reporting requirement should result in loss of the corporate charter.

H. *Voting Trusts and Proxies*

The use of a voting trust by the shareholders of a professional corporation is prohibited or restricted in several states.¹²⁴ While the voting trust device is not mentioned in the Ohio statute, it appears that the restriction placed on the identity of the transferee of shares¹²⁵ has the effect of preventing the use of a voting trust except when the trustee is a qualified transferee.¹²⁶

There is no such prohibition against granting a proxy to an unlicensed person or even to a person who has lost his license, even though such use of a proxy would be clearly contrary to the underlying legislative policy expressed by the shareholder licensing requirement.

¹²³ Of course, if the rationale of the 6th Circuit prevails, then even such a one shareholder professional association would be taxed as a corporation because of its status under local law. *O'Neill v. United States*, ___ F.2d ___ (6th Cir. 1969).

¹²⁴ See, e.g., IND. ANN. STAT. § 25-4911 (19___) (medical professional corporation).

¹²⁵ OHIO REV. CODE ANN. § 1785.07 (Page 1964).

¹²⁶ See, Z. Cavitch, note 100 *supra*, at 4.51(1).

The statute should be amended to specifically prohibit the granting of proxies to non-licensed persons and to make it clear that the transferee limitations also apply to voting trustees.

V. CONCLUSION

For all of its limitations, the Ohio professional association statute still represents a workable statute for professional persons who either agree on all important matters or, more likely, intelligently employ buy-sell agreements and use artfully-drawn articles of incorporation and codes of regulation. The buy-sell agreement will solve most of the problems that might otherwise arise upon the death, incompetency, or loss of license of a shareholder. It should also cover other matters of shareholder concern, such as transfers to outsiders. The qualification of directors and officers and the manner in which proxies and voting trusts are employed can be covered in the articles of incorporation or code of regulations.

Most of the problems associated with the limited purpose of a professional association will not arise. Many professional associations will not accumulate any substantial funds. Even if they do accumulate funds, more often than not no one will object to their investments. Furthermore, the accumulated earnings penalty tax acts as a barrier to the substantial accumulation of funds.¹²⁷

While the statute may be workable under ideal circumstances, it is not workable and presents substantial interpretive problems that will require years of litigation if the parties do not properly plan the corporate organization and subsequently do not agree. Moreover, the legislative policy of preventing unlicensed persons from providing professional services may be circumvented in many circumstances because of loosely-drawn or missing statutory language.

The statutory changes required to remedy this situation are easy to visualize. With only a few exceptions, the corrective language is contained in the statutes of one or more of the surrounding states.

To pass up this opportunity to remedy a statute which may soon become a major corporate statute, would be a disservice to the professions, to the public, and to the Bar.

¹²⁷ INT. REV. CODE OF 1954, § 531. See, Alexander, *Some Tax Problems of a Professional Association*, 13 WESTERN RESERVE L. REV. 212, 218-19 (1962).